Internal Revenue Service

memorandum

CC:TL:N-416-90
JDMacEachen

date: JAN 24 1990

to: District Counsel, Baltimore CC:BAL

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request for Tax Litigation Advice of October 11, 1989. The following response was formally coordinated with the office of the Acting Assistant Chief Counsel (Income Tax and Accounting), which concurs.

ISSUE

1) Whether the purported "pledge" of installment obligations as collateral for a publicly marketed bond issue constitutes the sale or other disposition of those obligations within the meaning of I.R.C. § 453B. 0453-0500.

2) Whether the form of the subject transaction reflects the economic substance of the transaction.

3) Whether the use of the installment method in this case clearly reflects income. 0446-0100.

CONCLUSIONS

1) Whether there has been a sale or other disposition of an installment obligation is a question of fact, i.e., whether the benefits and burdens of ownership of the installment obligation have shifted from the seller to the buyer. In the instant case, vis a vis the purchaser, the taxpayer has retained both the risk of loss and the potential to profit from the installment obligations, notwithstanding the fact that the taxpayer has, for a fee, insured itself against default on the installment obligations. Accordingly, we believe that there has been no sale or other diposition of the obligations for purposes of section 453B.

2) Given that the taxpayer has retained the benefits of ownership of the installment obligations, the substance of the transaction is reflected by its form, and the taxpayer is required pursuant to section 453(a) of the Code to report the income from the installment obligations on the installment method.

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3) The installment sale provisions were introduced into law to specifically counter case law holding that such transactions did not clearly reflect income. Accordingly, we do not believe that a transaction which otherwise qualifies for installment sale treatment is open to challenge on the basis that the use of the installment method does not clearly reflect income.

FACTS

The [redacted] ([redacted]) is a large residential home builder. [redacted] ([redacted]), is a wholly-owned subsidiary of [redacted], and is a GNMA, FHLMC, FHA and VA approved lender. [redacted] originates loans on behalf of [redacted] secured by a first lien on the purchaser's home. [redacted] services the purchase mortgages, and bears the responsibility for and expenses of collection of the monthly installments due. [redacted] is paid a servicing fee for these services.

After closing on a home sale, [redacted] sells the purchase mortgage to [redacted]. In a typical situation [redacted] accumulates the mortgages into a pool pursuant to the procedures required by the Government National Mortgage Association (GNMA). [redacted] then uses the pool to obtain a commitment from GNMA to guarantee an issue of Modified Pass-Through Certificates. These certificates entitle the holder to monthly payments based on the amortization schedule of the underlying mortgages and are guaranteed by the United States.

[redacted] ([redacted]) is a wholly owned subsidiary of [redacted]. [redacted] sells the certificates to [redacted], which borrows the purchase price of the certificates through the issuance of bonds in the public markets secured by a pledge of the certificates.

The certificates are held for the bondholders by a third party trustee (TRUSTEE). Absent default by [redacted] the rights of the bondholders are limited to receiving principal and interest payments on the bonds. The bondholders have no right to take or dispose of the certificates securing the issue and no right to prepayments on the mortgage loans securing the certificates. The bonds have a term equal to that of the certificates, which in turn have a term equal to that of the mortgage loans in the pool. The term is typically 30 years. [redacted]'s experience with its mortgage loans is that, because of prepayments, the loans have an average life of approximately [redacted] years. The bonds reflect this expected prepayment through a redemption provision. Under the bond indenture, [redacted] has the right to redeem the bonds beginning six years after their issuance, and it must redeem them when the value of the certificates falls to a predetermined level. Bondholders can request redemption of their bonds to the extent that there is a balance in the reserve fund due to prepayments on the mortgages.

During the years [redacted] through [redacted], [redacted], [redacted] and [redacted] were members of the same affiliated group within the meaning of I.R.C. § 1504(a), and filed consolidated returns for those years. [redacted]'s sale of the mortgages to [redacted], and [redacted]'s sale to [redacted] constituted deferred intercompany transactions within the meaning of Treas. Reg. § 1.1502-13(a)(2).

The question presented is not whether [redacted]'s initial sale of a home to a purchaser qualifies as an installment sale, but whether the pledge of the installment obligations to the bondholders constitutes a sale or other deposition of those obligations. It is uncontested that the bondholders are looking solely to payments on the certificates, (i.e., the mortgage payments), and not to [redacted], to pay off the bonds. [redacted] has no significant assets other than the certificates pledged to the bondholders. It is also uncontested that from an economic standpoint, after pledging the certificates, [redacted] has no further liability on the bonds.

DISCUSSION

I.R.C. § 453(a) provides that income from an installment sale shall be taken into account under the installment method. Section 453(a) defines an installment sale as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.

Section 453B(a)(1) of the Code provides that if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and the amount realized, in the case of satisfaction at other than face value or a sale or exchange.

No regulations interpret section 453B(a), but the wording of that section is identical to the wording of former section 453(d)(1). Under the re-enactment doctrine, the use of identical statutory language, without legislative history to the contrary, means that the accepted interpretation of that language is valid. See Provost v. United States, 269 U.S. 443, 458 (1926). Thus, cases and rulings interpreting former section 453(d)(1) are of assistance in interpreting current section 453B(a).

It was initially the position of the Service that the assignment of an installment obligation as security for a loan is a disposition of the obligation for the purposes of section 453.

See Rev. Rul. 65-185, 1965-2 C.B. 153; [redacted] G.C.M. 32840, I-1164 (March 18, 1965.) However, this position was not accepted by the courts, and the Service has acquiesced in those decisions. Town and Country Food Co. v. Comm'r, 51 T.C. 1049 (1969), acq., 1969-2 CB xxv; United Surgical Steel Co. v Comm'r, 54 T.C. 1215 (1970), acq., 1971-2 C.B. 3.

It is well settled that where the legal characterization of economic facts is controlling for federal income tax purposes, the tax consequences are determined by the economic substance of the transaction, and not the labels or the form placed on the transaction for property law purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Union Planters National Bank of Memphis v. United States, 426 F.2d 115 (6th Cir. 1970). "In the field of taxation, administrators of laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939).

The loan versus sale cases turn upon their own particular facts, with the ultimate classification of the transaction dependent upon whether there was a relinquishment of substantial incidents of ownership and which party bears the economic risk of loss.

In Town and Country Food Co. v. Comm'r, supra, the petitioner subjected certain installment obligations, along with other assets, to the lien of a chattel mortgage given to secure loans obtained under a line of credit from a third party. The petitioner retained title to, and possession of, the obligations, collected the payments when due, and made payments to the finance company that were unrelated to the payments collected on the obligations.

In holding that the arrangement did not constitute a disposition of the installment contracts, the Tax Court noted:

> Section 453(d) predicates its application upon the sale or exchange or other disposition of installment obligations. We think it is obvious that a disposition involves the relinquishment of the substantial incidents of ownership of the obligations. It may well be that in some instances involving claimed borrowing arrangements the taxpayer parts with such a substantial portion of his ownership rights in the obligations as to require the conclusion that he has, in effect, sold or otherwise disposed of the obligation. On the other hand, if it is clear that the taxpayer has merely subjected the obligation to a lien for the payment of indebtedness, he does not lose the privilege of reporting the income on the installment method.

51 T.C., at 1056, 1057.

In United Surgical Steel Co. v. Comm'r, supra, petitioner entered into a loan agreement with a third party bank under which petitioner assigned installment obligations to the bank and became entitled to borrow up to 88 percent of the face amount of such obligations. The petitioner continued to make all collections on the obligations, which were deposited daily in a special bank account. The funds once deposited could not be withdrawn by the petitioner but the total amount on deposit was credited to the petitioner's revolving account on a weekly basis. In the case of a default on any installment obligation, the petitioner was required to reduce its account with the bank by an equal amount and the obligation was released from escrow to the petitioner. Based on the foregoing, and its holding in Town and Country Food Co., the court concluded that there had been no disposition of the installment obligations within the meaning of section 453(d). See also Yancy Bros. Co. v. United States, 26 AFTR 2d 70-5564 (D. Ga. 1970).

Following these decisions the Service concluded that each case turns on its own facts in determining whether the transfer of an installment obligation is a "disposition" within the meaning of section 453. See [redacted], G.C.M. 34602, I-4188 (Sept. 9, 1971); [redacted], G.C.M. 37848, I-509-76 (February 5, 1979). The critical inquiry is whether or not there was a relinquishment of substantial incidents of ownership, and the G.C.M.s set out eleven factors that are useful in the resolution of this issue.

The first factor is whether [redacted] or [redacted] is obligated to collect the mortgages and bear the expenses in connection with their collection. Here, [redacted] collects the mortgages, although admittedly it is paid a servicing fee to do so.

The second factor is whether [redacted] or [redacted] is liable for property, excise, sales or similar taxes. Here, [redacted] is required to pay all taxes associated with the mortgages.

The third factor is whether [redacted] must hold [redacted] harmless from and against any action brought against [redacted] arising out of [redacted]'S actions in making collections. Here, where [redacted] is paid a servicing fee, [redacted] assumes any such liability.

The fourth factor is whether [redacted], a credit subsidiary of [redacted], is really a shell corporation. Here, it is uncontested that [redacted], with a net equity of $[redacted], is little more than a shell corporation. Indeed the prospective bond purchasers were warned that they could not look to [redacted] in event of default.

The fifth factor is whether [redacted] home buyers are notified of any change in the ownership of their mortgages. Here, the mortgagors are unaware of the pledge of their mortgages to TRUSTEE.

The sixth factor is whether TRUSTEE retains the right to inspect the records of [redacted] at any time. Here, TRUSTEE has such right in that it is entitled to receive audited financial statements as well as other quarterly statements. However, there is no provision for [redacted] to turn its records over to TRUSTEE.

The seventh factor is whether the servicing of the mortgages is performed by [redacted], and if so, whether TRUSTEE supervises [redacted]'S operations. Here, [redacted] is paid a servicing fee to service the mortgages, and other than the receipt of financial statements, there is no indication that the TRUSTEE has any right to supervise [redacted] in this regard. It must be remembered that it is the guarantor, GNMA, and not TRUSTEE, who has the real interest in seeing that the mortgages are properly serviced.

The eighth factor is whether the transaction provides for a fixed price. Here, it does. [redacted] has sold the mortgages to [redacted], and [redacted] has sold them to [redacted], in each case for a fixed price. The bondholders have in turn agreed to advance [redacted] a fixed amount of dollars in exchange for the "pledge" of a fixed amount of certificates.

The ninth factor is whether [redacted] or TRUSTEE bears the risk of loss in the event of a default. Here [redacted] initially bore the risk of loss upon default by a home buyer. However, [redacted] has shifted the risk of loss for a fee to GNMA, the guarantor. Thus, as between [redacted] and TRUSTEE, neither bears the risk of loss at the time the mortgages, now certificated, are pledged to TRUSTEE.

The tenth factor is whether [redacted] or TRUSTEE holds the possibility of gain from appreciation of the mortgages. Here, absent default, [redacted] retains the right to substitute collateral, provided the substitute certificates are of equal collateral value and maturity date. Thus, in the event of a decline in interest rates, and a corresponding increase in the value of the pledged certificates, [redacted] may substitute certificates of a lower market value, and profit by selling the original certificates for more than the cost of the replacements. On the other hand, absent default, TRUSTEE has no right to dispose of the certificates. Further, [redacted] has retained the right to prepay the bonds in certain instances, and thus receive the pledged certificates, which it would then be free to sell.

The eleventh factor is whether TRUSTEE has the power of alienation. Here, as noted above, absent default, TRUSTEE may not sell the certificates.

With the exception of factor number 4, the subject transaction is overwhelmingly a pledge rather than a sale of the certificates. Both in form and substance [redacted] has retained the substantial incidents of ownership of the certificates and should be considered the owner.

G.C.M. 37848 also states that, generally, if the seller retains the risk of loss, the transaction will be characterized as a loan unless the total purchase price is fixed when the transfer occurs and the purchaser obtains the benefit of any profit through appreciation in value of the obligations due to a drop in the prevailing rate of interest by obtaining the power to dispose of the obligations. This shorthand summary of the principles stated above focuses primarily on the risk of loss and possibility of gain. If both are retained by the seller the substance of the transaction is generally a loan and not a sale.

We believe it is clear in this case that both the risk of loss and the possibility of gain reside with [redacted] vis a vis TRUSTEE, notwithstanding the fact that [redacted] has, for a fee, insured itself against the mortgagors' default. To the extent interest rates decrease, [redacted] stands to profit either by the substitution of less valuable collateral or by the prepayment of the bonds. The bondholders' interest in this publicly marketed transaction is that of a secured lender seeking to gain through the interest it is charging [redacted].

In short, we doubt that a court would view this transaction as other than a pledge of the certificates by [redacted]. [redacted] remains the owner of the certificates and there has been no sale or disposition for purposes of section 453B.

Thus, based on the foregoing, we agree that the government is not likely to prevail on the disposition issue. However, the question remains whether the form of the entire transaction reflects the substance. After all, it is the expectation of all parties to the transaction that [redacted] was to have the bond proceeds but no liability on the bonds. The bondholders have in effect agreed to look solely to the mortgage payments of the home buyers, or in the event of their default, those of the guarantor, to satisfy the bonds. [redacted] is claiming installment treatment in a transaction where the only party receiving installment payments is the bondholders.

We believe that this question is in essence a variation of the question of whether [redacted] disposed of its installment obligations. From a technical standpoint, by retaining the beneficial ownership of the installment obligations, [redacted] is required to compute income on the installment method. See section 451(a) of the Code and Temp. Treas. Reg. § 15A 453-1(d), both indicating that an installment sale is to be reported on the installment method unless the taxpayer effectively elects otherwise. However, viewing the transactions as a whole focuses on the real issue, i.e., whether [redacted]'S use of the installment method clearly reflects income.

The purpose of the installment method was to enable sellers to receive in cash the profit upon which tax is payable prior to having to pay the tax. See Prendergast v. Comm'r, 22 B.T.A. 1259, 1262 (1931). Unfortunately, this question was answered long ago in the affirmative. As the Tax Court noted in Wacker v. Comm'r, T.C. Memo 1980-324, 40 T.C.M. (CCH) 1009, 1018:

> In general section 453 is a relief measure which enables a taxpayer who sells property under a qualified installment sales contract to defer reporting portions of realized gain until his future receipt of the installments in cash or its equivalent. Congress has clearly stated that the purpose of enacting this special treatment for certain installment sales is to allow a taxpayer to avoid income bunching upon receipt of the purchaser's installment obligation in the year of sale and instead to "clearly reflect income" during the years following the sale. S. Rep. No. 52, 69th Cong., 1st Sess. (1926), 1939-1 C. B. (Part 2) 332, 346; H. Rep. No. 356, 69th Cong., 1st Sess. (1926), 1939-1 C.B. (Part 2) 361, 363; H. Rep. No. 91-413 (1969), 1969-3 C.B. (Part 1) 200, 267.

Congress' reference to the clear reflection of income was made necessary in light of the fact that prior to the Revenue Act of 1926 the Board of Tax Appeals had held the installment method invalid on the basis that it did not clearly reflect income. See B.B. Todd, Inc. v. Comm'r, 1 B.T.A. 762 (1925). The purpose of the Act was to reverse Todd and similar decisions, and to validate the installment method. See S. Rep. No. 52, 69th Cong., 1st Sess. (1926), 1939-1 C.B. (Part 2) 332, 347.

While we agree that the use of the installment method does not seem appropriate under these circumstances, we do not believe that either the statute or case law would support the denial of the installment method in this case.

If you have any questions, please call John D. MacEachen of this office at FTS 566-4189.

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